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TEST # 30  
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## Complying With Franchise Law *A dramatic increase in the number of franchises creates a corresponding growth in their regulation*

BY DAVID GURNICK

Franchising is a business method that provides franchisees with ownership of their own business, together with guidance and stability of being in a larger enterprise. It lets franchisors increase the number of outlets, with capital, locations and workers paid for by others. Franchisees benefit from the franchisor's experience, cost savings from collective purchases of inventory and advertising, and association with an established brand. In exchange, franchisees pay fees to a franchisor, typically royalties based on a percentage of franchisee sales.

Franchising has grown dramatically. Today, more than 4,000 franchise systems operate in the United States, employing more than 8 million people at tens of thousands of locations, accounting for more than one-third of all retail sales. With franchising's growth, regulation has increased. An FTC rule requires presale disclosures and a cooling off period before a franchise may be sold. (16 C.F.R. §§436.1 et seq.) California and 16 other states have franchise registration laws. As a result, lawyers have more occasions to advise on franchise law compliance, and on legal disputes involving franchised businesses.

### The nature of a franchise

Franchises are business relationships in which three basic elements are present. **1.** One company (the franchisor) grants another (the franchisee) the right to offer or sell goods or services using a marketing plan or system provided by the franchisor. **2.** The franchisee's business operates in substantial association with a trademark of the franchisor. **3.** In exchange, the franchisee pays the franchisor a fee. (Corps. Code §31005.)

**The Marketing Plan** A typical franchise arrangement involves control by a franchisor over a franchisee's choice of location, goods and services that the franchisee sells, operating hours, accounting practices and advertising. The marketing plan element may be present if the franchisor provides training, or helps a franchisee in management and marketing; if the franchisee receives an exclusive marketing territory, if the franchisor provides advertising, or if the system has procedures for inspection by or reporting to the franchisor on the business.

The Department of Corporations, which regulates franchises in California (Corps. Code §§31004; 31211), views almost any form of business assistance as potentially satisfying the marketing plan element. (Comm. Op. 3-F (June 22, 1994, revision).) However, an agreement imposing only procedures that are customary in the particular business are not a marketing plan for franchise law purposes. Thus, for example, obligations to exert best efforts, to increase sales, or to obtain insurance coverage for a business, by themselves, will not establish a marketing plan.

**Trademark element** The trademark element is satisfied when a franchisee operates in substantial association with the franchisor's brand name. Typically, a franchisee promotes the brand to the public. But this element may be present when a franchisee has a right to use a mark, even if it is not presented to customers. (*Kim v. Servosnax* 10 C.A.4th 1346 (1992).)

**Franchise fee** A franchise fee potentially includes any charge that a franchisee must pay for the right to enter into a franchise arrangement. Typical are royalties, rents or payments for training, advertising, promotion materials, supplies or other services. Purchases from third parties in which a franchisor receives revenue can also be a franchise fee. Under the federal rule, the franchise fee element is satisfied by required payments to a franchisor totaling \$500 or more up until the franchisee has operated for six months. (16 C.F.R. §§436.2(a)(2); 436.2(a)(3) (iii).) However, under the federal and California laws, a franchise fee does not include purchases of goods at bona fide wholesale prices if the franchisee was not required to buy more than a reasonable business person would normally buy for inventory.

### Registration and pre-sale disclosure regulation

The FTC's franchise rule and many states' franchise laws emphasize presale disclosure. They try to ensure that prospective franchisees receive detailed information so they can make informed decisions whether to invest in a franchise being offered, and to prohibit sales of franchises when it is likely that the franchisor's promises will not be met. (Corps. Code §31001.)

The required presale disclosures are 22 categories of information covering the franchisor's business background, litigation history, all payments to the franchisor, an estimate of the franchisee's investment, territory granted to the franchisee, training and other help that the franchisor promises to provide, and the terms of renewal and termination. When

a franchisor wants to tell franchisees how much they can earn, the claim must have a reasonable basis and be supported by substantiation. These disclosures are made in a prospectus, called a “Uniform Franchise Offering Circular” or “UFOC.”

Whereas the FTC rule only mandates disclosure (the FTC does not “register” franchises), California and several other states require franchisors to register before they may offer a franchise in the state. (Corps. Code §31110.) Franchisors must comply with both the federal and applicable state franchise laws. Registration in California requires filing an application with the Department of Corporations, which includes the proposed UFOC. Registration may be granted after examination of the application, and possible revision to address comments from the examiner.

Registrations normally last one year. (Corps. Code §31120.) To continue selling franchises, the franchisor must renew the registration annually, and update the UFOC, sooner more often, whenever there is any material change to its information. The department has authority to deny, suspend or revoke a registration on finding that the offer or sale of the franchise would involve misrepresentation, deceit or fraud to purchasers. (Corps. Code §31115.)

Some franchisors qualify for exemptions from registration. These franchisors need not register. California has exemptions for experienced franchisors whose net worth exceeds \$5 million if they conducted the business or have 25 franchisees; a franchisee’s sale of their own franchise; franchises to be both owned and located outside the state; and franchises sold to a franchisee who meets criteria establishing prior experience in the business. (Corps. Code §§31101; 31102; 31105; 31106; 31108.) Many exemptions require filing a public notice of reliance on the exemption. (Corps. Code §31101, 31106, 31108.) Because the state’s exemptions do not always parallel those of the FTC, a franchisor exempt from state requirements may still need to satisfy federal presale disclosure rules. This means a UFOC must still be presented to prospective franchisee.

A franchisor must provide the offering prospectus and copies of all proposed contracts at the first face-to-face meeting to discuss the possible sale of a franchise, or at least 10 business days before the franchisee signs any agreement or makes any payment regarding the franchise, whichever is the earliest. (16 C.F.R. §§436.1(a); 436.2(g); 436.2(o); Corps. Code §31119.) The structure of the law means a franchisee will always have a cooling off period of at least 10 business days.

## **Regulation of the ongoing franchise relationship**

California, like a number of states, also restricts a franchisor from terminating a franchise before its term ends, or from refusing to renew an expiring franchise agreement. (Bus & Profs. Code §§20020; 20025.) These laws protect franchisees against losing their substantial investments unless the franchisor has “good cause” for its action. (Bus & Profs. Code §20020.)

Good cause means a franchisee’s failure to comply with a lawful requirement of the franchise agreement after notice and an opportunity to cure. (Bus. & Profs. Code §20020.) A number of other statutory events can also be good cause, such as a franchisee’s abandonment of the business, an uncured violation of the law, repeated noncompliance with the agreement (even if prior incidents were cured) or operating in a way that threatens public health or safety. (Bus. & Profs. Code §20021.)

California also protects spouses and other heirs of a franchisee against forfeiture due to death of the franchisee. The Franchise Relations Act mandates that if a franchisee dies, the spouse and other heirs must be given an opportunity to participate in ownership of the franchise before the franchisor can use the death as grounds for termination. (Bus. & Profs. Code §20027.)

## **Accidental franchises**

Some people mistakenly think if a business relationship is called a “license” or given another name, franchise law compliance is not needed. This is incorrect. Any business arrangement may be a franchise if the three key elements are present (marketing plan, trademark and franchise fee). Also, a franchisor cannot avoid compliance by seeking a waiver from a franchisee. An agreement purporting to waive the franchise law is void. (Corps. Code §31512; Bus. & Prof. Code §20010.)

Transactions that deviate from traditional franchise arrangements may still fall within the definition of a franchise. One example is an agreement granting an exclusive right to sell a product in a stated area. If a distributor must buy advertising from a manufacturer or maintain an excessive inventory, the fee element may be present. If a manufacturer recommends marketing methods, such as in an operating manual or product specifications, the marketing plan may be present. The product’s name or a distinctive logo associated with the product may satisfy the trademark element. If all three elements are present, the arrangement would be subject to federal and state franchise laws. See e.g., *Gentis v. Safeguard Systems* 61 C.A.4th 886 (1998).

Unknowningly entering into a franchise arrangement creates unexpected risks and costs for all parties. Anyone who sells a franchise in violation of the registration and prospectus delivery requirements is liable to a franchisee for damages (Corps. Code §§31300; 31301) and for willful violations, a franchise may rescind the agreement (Corps. Code §§31300; 31301.) There is also exposure to civil and potentially criminal penalties. *People v. Gonda* 138 Cal. App. 3d 774 (1982) (felony conviction under Franchise Investment Law).

If a relationship is a franchise, the franchisor cannot terminate it except in compliance with the franchise relationship laws. (Bus. & Profs. Code §§20000; 20020; 20021.) The franchisor may even be compelled to renew the agreement if

the franchisee wants. (Bus & Profs. Code §20025.)

The FTC Franchise Rule has no private right of action that can be asserted by a franchisee against a franchisor. (See e.g. *Morrison v. Back Yard Burgers Inc.* 91 F.3d 1184, 1187 (8th Cir. 1996).) However, civil and criminal sanctions are available in an action by the FTC against a franchisor, including substantial monetary penalties and the ability to require refunds of money, return of property to a franchisee or payment of damages.

■ *David Gurnick is a partner with Arter & Hadden LLP in Woodland Hills, where his practice emphasizes franchise law, antitrust and unfair competition, trademarks and copyrights and software technology.*

## Test

### 1 Hour MCLE Credit

1. Today, every state in the nation has its own law regulating offers and sales of franchises.
2. Before a franchisor can sell a franchise, the franchisee is entitled to a three-day cooling off period.
3. When one company provides another with a marketing plan for selling goods or services, in substantial association with the licensor's trademark, all in exchange for a fee, the relationship is a franchise.
4. Assistance in the form of training, guidance about management marketing and personnel, the grant of an exclusive territory, restrictions on operating hours, all may indicate the presence of a marketing plan.
5. An agreement that imposes procedures or techniques that are customarily observed in the particular business, are not a marketing plan for purposes of the franchise law.
6. It is possible for a company to be deemed to have operated in substantial association with a franchisor's trademark, even if the trademark is not presented to customers.
7. Royalties, rents, payments for training, advertising or supplies, or the wholesale purchase of inventory for resale at bona fide wholesale prices, are all examples of charges that may be a franchise fee.
8. Under the FTC franchise rule, the franchise fee element is satisfied by required payments from the franchisee to the franchisor totaling \$500 or more up until the time the franchisee has operated the business for six months.
9. Franchisors selling a franchise in a state that has its own franchise law, must comply with both the federal and state franchise laws.
10. Before a franchisor can offer or sell a franchise, the franchise must be registered with the Federal Trade Commission.
11. Franchise laws seek to provide pre-sale disclosure to prospective franchisees so they can make informed decisions about whether to invest.
12. The presale disclosures that a franchisor must make are limited to the franchisor's history, the background of its officers, and how much money a franchisee can make.
13. California requires franchisors to register with the state before making any offer or sale of a franchise in this state.
14. After registering with the state once, a franchisor may offer and sell franchises perpetually, for as long as it continues to act as a franchisor.
15. All franchisors who offer or sell franchises in the state must register regardless of their size or experience.
16. California's franchise laws apply during the sale process, and also at the termination or nonrenewal of a franchisee.
17. The Franchise Relations Act gives heirs of a deceased franchisee an opportunity to participate in ownership of a franchise.
18. Referring to a business relationship as a "license" avoids the need to comply with the franchise laws.
19. It is not necessary to comply with the franchise investment law or franchise relations act if the franchisee signs a knowing waiver of the law before a notary public.
20. There is no private right of action against a franchisor for violating the FTC Franchise Rule.

### Certification

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- The State Bar of California certifies that this activity conforms to the standards for approved education activities prescribed by the rules and regulations of the State Bar of California governing minimum continuing legal education.

# MCLE ON THE WEB

## TEST #30 — Complying With Franchise Law

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